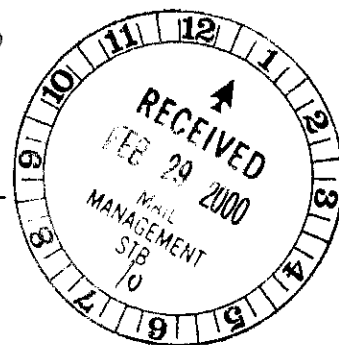


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**BEFORE THE
SURFACE TRANSPORTATION BOARD**



FEB 29 2000

Part of
Public Record

STB Ex Parte No. 582
Public Views on Major Rail Consolidations

**Written Comments of the California Public Utilities Commission
To Be Presented at the March 10, 2000 Public Hearing**

I. Introduction.

The California Public Utilities Commission (Commission) welcomes the opportunity to present its views on issues related to rail industry consolidation. As merger activity continues and the number of railroad companies shrink - and yet another large merger now looms on the horizon - we may be arriving at a critical juncture for the future of the rail industry.

The Commission has been active in numerous proceedings before the Surface Transportation Board (Board), including rail mergers, the subject of Ex Parte 582, and various rulemakings. We participated in both the Burlington Northern and The Atchison, Topeka and Santa Fe, and the Union Pacific (UP) and Southern Pacific (SP) railroad merger proceedings, which together have defined the current structure of the rail industry in the West. Additionally, the Commission is the state agency with primary responsibility for rail safety.

The importance of rail service to California's economy cannot be overemphasized. Our seaports are among the most active in the world and serve as key gateways for vast

amounts of this country's rail-transported exports and imports. Our agricultural and other products are distributed across the country by rail. In fact, California's economic well being depends heavily on its diverse industries obtaining the safest, highest quality rail service at prices that are reasonable from the perspective of both shippers and their railroads. These considerations are California's paramount concerns in the following comments and recommendations.

II. Our responses to the issues raised in Ex Parte 582.

One question the Board is seeking comments on is whether is it prudent to allow more restructuring of the rail industry while it is still recovering from service difficulties and other disruptions associated with implementation of prior recent rail mergers.

Both California and the nation's rail users have experienced significant economic hardship as a result of recent mergers. The UP/SP merger resulted in widespread service failures. Shippers are still recovering from disruptions caused by the Conrail split-up initiated last June. How long the current situation in the East will continue is difficult to gauge; any new shock to the nation's rail network would most likely result in delaying recovery.

At a minimum, any merger will result in some adjustments to existing shipping patterns because new routings are created, services change, and administrative functions are streamlined as they are integrated into the new organization. Whether these adjustments and alterations become so severe that service begins to suffer and nationwide gridlock occurs is difficult to predict; some recent mergers were implemented with no major disruptions.

Clearly, putting the nation's economy at risk from another railroad service meltdown should be avoided. Prudent steps should be taken to prevent prolonged service failures. One method of avoiding the serious economic problems of the kind resulting from the UP/SP merger and the Conrail split-up would be to postpone consideration of any new merger until the industry has fully adjusted to the current restructuring. This, however, may be considered by some as an extreme measure. Of course, taking any action that unnecessarily delays realization of the public benefits and efficiencies that result from consolidation, likewise would not be in the public interest.

Striking the right balance between delaying a merger and allowing it to proceed unabated requires the development of sufficient information to analyze the potential for further destabilization of rail service. Thus, it is reasonable to require the parties proposing a consolidation to provide specific measures ensuring that rail service will not be adversely affected.

In addition to the timing of a proposed transaction, the Board should also consider how merger related service problems can be avoided. While past events indicate that service disruptions may be inherent in the consolidation of large railroads, identification of the root causes of these situations may offer a means toward their prevention.

A fundamental key in facilitating a smooth transition in future mergers and in preventing service failures is to develop the overall public benefit during the planning and implementation phase. That is, the overriding goal of a merger should not be just to reduce costs or maximize short-run financial gains, but to develop a rail system that meets the nation's long-term needs for safe, high quality service at fair rates while treating rail

employees equitably. Attaining this desired outcome requires a collaborative or partnership approach that draws upon the views of all the merger's stakeholders – railroad management, shippers, rail employees, shortline as well as other railroads, and government regulators.

In our recommendations, we identify such partnerships in the merger's planning stages and in the formulation of contingency plans to avoid service problems.

Another question the Board has raised is whether parties believe that strategic responses engendered by another large railroad consolidation may lead to significant additional consolidation or any other changes in the structure of the rail industry or in the way it is regulated.

History has shown that rail mergers have resulted in continued consolidation and concentrations. In 1976, as many as 30 independent Class I railroads served the country. Today there are only seven. In California, the number of Class 1 carriers serving the state has shrunk from four to two during the 1990's. Many regions of the state now receive service from these two carriers under an extensive trackage rights arrangement designed to maintain some competitive balance.

This continued concentration has occurred because the economies of scale of a merger tend to improve service levels for the new operation. These initial improvements motivate shippers to re-direct their business from existing railroads to the new combination. The existing rivals of the new railroad are, in turn, compelled to react to regain lost revenue through the creation of their own economies of scale through merger with a compatible partner. This was the scenario evident in the most recent merger

involving major western carriers, the combination of the Union Pacific and Southern Pacific systems in 1996. It was a reaction to the 1995 merger of the Burlington Northern and the Santa Fe Railroads.

If the merger trend of recent years continues, it is reasonable to conclude that the nation's rail system will ultimately consist of only two major transcontinental systems. One result of such an outcome may be the need for an increased federal regulatory presence in a rail transportation marketplace which provides so few competitors.

The implications to government regulators of such a duopoly are significant. One is the level of pricing power a two-carrier industry may wield over its customers. Certainly, shippers of bulk materials such as coal and grain, whose commodities are not suitable for alternate modes of transport, are at a greater risk from such market abuse. An acknowledgement of the critical relationship between price and competition in the rail industry was presented in an April 1999 U.S. General Accounting Office (GAO) report reviewing changes in service and rates during the 1990's. Indicating that rates had fallen in general, the study concluded that "rail rates were also sensitive to competition, and the GAO found that rates in some markets/corridors that are considered to have less effective competition, such as the northern plains states, were generally higher than rates where there may be more effective competitive options, such as barges or other railroads." "Railroad Regulation Changes in Railroad Rates and Service Quality Since 1990," April, 1999, at p. 6.

Indications that there may be more pressure to raise rates in the future can be seen from a review of carrier rate levels and profitability over the two decades since passage of

the Staggers Rail Act of 1980, when economic regulation was substantially reduced. During this period of increased ratemaking freedom, rail transportation rates have generally decreased, yet the financial position of the rail industry improved. This was the result of reduced capital expenditures due to excess capacity created during the pre-1980's era of extensive government regulation. In the future, system capacity will have been substantially optimized. And, of course, in an optimized capacity era a duopoly will look to increased rates to offset increased costs. Major railroads have recently announced rate increases. Under these circumstances, there may well be a greater need to protect consumers and shippers through increased government oversight of rates.

There are, of course, several factors that may mitigate the possibility that, in a highly concentrated industry, a carrier will engage in anti-competitive pricing in the absence of government regulation. One such factor is the extent to which a shipper's facilities and its customers may be served by more than one carrier. This end may be achieved through the use of trackage rights or other means of additional access, such as joint ownership of track. Further, additional gateways may be created for the open interchange of railcars between carriers allowing shippers to negotiate rates with other carriers that may serve various segments of a route. Such expanded routing and ratemaking freedom may reduce any unfair competitive advantage a so-called "bottleneck" carrier possesses in controlling a key segment of the route.

The level of government intervention necessary in a more concentrated industry can be considered on a spectrum. At a minimum, focused monitoring and analysis of rail rates and other economic data will be necessary to assess the competitiveness of the

market. At the first sign of anti-competitive behavior, additional measures ranging from streamlined procedures for shippers to challenge unreasonable rates to rigid regulatory control should be considered. We offer additional proposed consumer protection programs in our recommendations.

The final merger related issue we would like to address is whether significant new consolidations in the rail industry will be a good thing for large and small railroads, their customers and employees, and the public generally.

Because of the adverse impact on service resulting from recent large mergers, future mergers must be viewed with skepticism. The burden should be placed on the merger proponents to provide probative evidence that their proposal is worthy of support.

From a longer term perspective, a new consolidation may be supportable if the public benefits cited as the justification for most mergers, such as improved transit times and increased rail car utilization rates, are guaranteed through the achievement of well-defined milestones.

Certainly a merger is not beneficial if it results in reduced levels of operational safety. The Federal Railroad Administration (FRA) recently raised a concern that in large mergers, the vast distance between corporate decision-makers and workers can cause communication and coordination difficulties, which, in turn, can have an adverse effect on operational safety. As the FRA stated in its First Briefing Report on Conrail Merger Surveillance dated May 4, 1999, "The vast size and complexity of the rail operations on these mega-carriers pose significant obstacles to effective communications and coordination elements that are critical to both railroad safety and service." We agree that

this is a worrisome prospect in large mergers. In the case of an international combination involving a U.S. carrier, we also have a concern that some necessary safety oversight authority might be lost to the U.S. because of differences in the respective countries' safety regulations creating questions about U.S. jurisdiction and enforcement authority.

III. Our recommendations.

a) To prevent or react to short-term service failures when mergers are implemented:

Merger applicants should prepare plans in cooperation with all other stakeholders - railroad management, shippers, rail employees, shortline as well as other railroads, and government regulators - showing how the merger will be implemented and the steps to be taken to avoid service problems; such plans should be filed with the Board. Measures should be incorporated into the plan to quickly assess whether service levels have begun to deteriorate so that swift action may be taken to head-off a more pervasive decline. Contingency plans to deal with this possibility should be prepared beforehand and designed to be enacted promptly. These plans could include agreements with other carriers to use their routes or expanded shortline connections to relieve congestion. Maintaining safe operating conditions must also be included in contingency plans. The Board should facilitate the development of such contingency plans, and be prepared to take any necessary regulatory action as well as engage in operational monitoring.

b) To best assure most effective government oversight in a consolidated industry:

The Board should review its data collection efforts (e.g. waybills, transit times etc.) to ensure the adequacy of the information collected concerning rates and service. It

should expand its analytical capabilities to timely review the data to determine whether anti-competitive practices are occurring and issue reports on a regular basis describing the degree of competition in the rail industry.

The Board should continue to review its procedures, examining whether further refinements are needed to its analytical framework to determine whether a rate is unreasonable. It should streamline its filing and data requirements to ease the administrative burden on protestants. One method of streamlining complaint cases is to create a “threshold” level of service and price. Doing so would place the burden of proof on the railroad to demonstrate that its rate or service action is fair. For example, any proposed rate increase greater than a widely recognized cost index (e.g. the producers price index) should be presumed unreasonable unless adequately justified by the Railroad. This streamlined approach would particularly help small shippers without sufficient means to bear the expense of a fully adjudicated rate complaint case.

Merger applicants should report to the Board on the status of achieving the public benefits (e.g. improved transit times, capacity improvements, better equipment utilization, etc.) used as justification for the merger. Specific milestones should be defined by the Railroad. Shippers should be able to seek damage awards if the claimed benefits are not realized (see our consumer protection recommendations below).

Commercial centers with a high concentration of traffic from varied sources and serving as key distribution points (such as seaports or major coal producing areas; so-called “common funnels”) should receive heightened scrutiny from the Board since anti-competitive effects here will have a widespread impact.

b) To assure there is an expedient consumer protection program targeted toward merger service failures:

Existing Board complaint procedures should be augmented to provide shippers experiencing a significant service problem with a cost-effective method of obtaining effective relief and damages, if warranted. These new procedures could include:

- Simplified notification procedures, such as an internet based system for submitting complaints or 800 phone number “hot line” for shippers to report service failures. (This simplified procedure would provide the Board with immediate, current information about service conditions.)
- Creation of an escrow account funded by the merged railroad and monitored by the Board that would allow shippers to seek compensation for damages if the benefits claimed by the merged railroad are not fulfilled and/or service suffers.

c) To assure that the adverse effects of abandonments and capacity reductions are minimized:

The Board should view abandonments from a forward looking perspective in addition to current or past levels of traffic because the loss of rail service, particularly to small communities, can dampen future economic growth. Routes proposed to be abandoned should be reviewed within the context of whether they may serve as overflows to ease congestion occurring on other more preferred lines, or provide additional capacity for future rail traffic. Additionally, consideration should be given to the potential that a route proposed for abandonment may have for providing future access to a particular

region by another competitor. In all cases, the views of local shippers should be carefully considered.

e) To best assure the safest railroad operations:

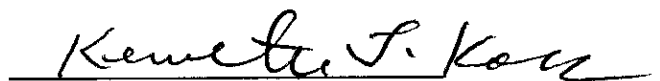
The Board should continue to work with the FRA and the states to ensure that mergers are implemented safely. The continued use of safety integration plans and corresponding FRA monitoring is essential for future mergers.

In the case of large international mergers involving U.S. railroads where foreign laws may also govern system-wide operational safety, the Board should work to assure that the U.S. portions of merged operations remain fully subject to U.S. safety regulations.

Prior to the merger's effective date, the Board should require a review of FRA-administered safety inspections to determine whether adequate safety will be maintained. Railroads with below average safety records should not be permitted to merge unless a detailed and practical safety program is developed and instituted.

Dated: February 28, 2000

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "Kenneth L. Koss", written over a horizontal line.

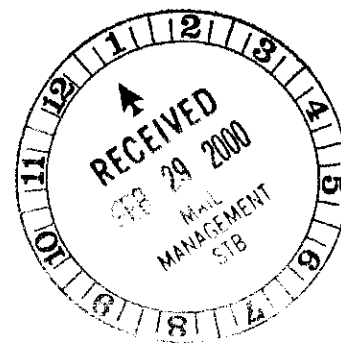
KENNETH L. KOSS

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 582
Public Views on Major Rail Consolidations



**Summary of Written Comments of the California Public Utilities Commission
To Be Presented at the March 10, 2000 Public Hearing**

These comments are presented in response to the Surface Transportation Board's (Board's) solicitation of public views in this proceeding.

California's diverse economy requires the availability of reasonably priced, safe, high quality rail services, and the comments and recommendations we present to the Board here are intended to help insure such services remain available for the future.

Existing Service Disruptions and New Rail Mergers

Recent past rail mergers have caused widespread traffic congestion and severe service disruptions, to which shippers are still adjusting. It may be prudent for the Board to delay new mergers until the rail market normalizes. However, to avoid postponing the public benefits mergers could create, an alternative may be to identify and analyze the causes of past problems and allow new mergers to proceed with an eye toward closer oversight and prevention.

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Mergers Stimulate More Mergers, and May Create the Need for Closer Regulatory Oversight

History shows that a rail merger generally stimulates the competitors of the merging systems to pursue combinations of their own with other systems that are compatible. This activity is further promoted because cost reducing economies of scale can be realized through the gradual reduction of the excess capacity created during the period prior to the 1980's when the railroad industry was subject to strict price and service regulation. However, continued merger activity will ultimately require Railroads to pass increased costs to shippers through rate increases. In fact, if the number of national railroads is reduced to two or three competitors it is likely that the Board will need to emphasize consumer protection through close oversight of railroad rates.

Is Continued Merger Activity Beneficial?

If effective long-run price competition can be maintained, significant new rail consolidations might generally benefit railroads, users and the public through improved service, greater efficiencies, increased traffic and more investment. In the short run, however, safeguards ensuring system integration and the prevention of service disruptions will be necessary.

The public may be harmed if steps are not taken to ensure continued safe operations. When large railroads consolidate into larger ones, there must be close oversight by the Board and the Federal Railroad Administration (FRA) to insure that resulting complexities in decision-making and corporate communications do not adversely impact safety.

Our final safety concern is that U.S. jurisdiction and rail safety laws continue to apply over U.S. portions of U.S. and foreign rail combinations.

Our Recommendations

- Future merger applicants should:
 - Have implementation plans prepared and submitted to the STB that include: 1) the steps that will be taken to avoid service problems, and 2) the special measures to be taken should service levels begin to deteriorate
- Be required to:
 - Periodically report on the status of achieving any public benefits (e.g. by the railroads – improved transit times, capacity improvements) presented as justification for the merger.
 - The Board should develop plans for specific regulatory action prior to granting a merger in the event that service quality begins to fail.
- The Board should also:
 - Ensure that its data collection capabilities are sufficient to permit it to react immediately should service prove to be adversely affected by the merger.
 - Expand its analytical capabilities to quickly process and review economic data to determine whether anti-competitive practices are occurring.
 - Issue periodic reports describing the degree of competition in the rail industry.
 - Examine whether further refinements are needed to the Board's economic analyses and capabilities to quickly determine whether rates are unreasonable.
 - Identify commercial centers with high concentrations of traffic from varied sources which serve as key distribution points (such as seaports or major coal producing areas – so called “common funnels”) and give them heightened scrutiny, since any anticompetitive effects at these points will have widespread impact.
 - Create a “threshold” level of service and price (perhaps, in the case of price, a recognized cost index could be employed) for use in complaint cases concerning rates.

- Augment existing complaint procedures to provide shippers experiencing significant service problems with a cost-effective method of obtaining merger-related relief and damages where warranted.
- View abandonments: 1) from a forward looking perspective - rather than just using current or past levels of traffic - in an attempt to ensure the economic growth of small communities will not suffer, and 2) from a critical viewpoint since the lines the railroads might seek to abandon could serve to ease congestion occurring on other more preferred lines and/or provide additional capacity in the future.
- Continue to work with the FRA and the states to: 1) ensure that mergers are implemented safely through the use of Safety Integration Plans, and 2) in the case of large international mergers involving U.S. railroads where foreign laws may also govern system-wide operational safety, assure that the U.S. portions remain fully subject to U.S. safety regulations.
- Prior to a merger's effective date, require a review of FRA-administered safety inspections to determine whether adequate safety will be maintained. Railroads with below average safety records should not be permitted to merge unless a detailed and practical safety program is developed and instituted.